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IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1991

KRAFT GENERAL FOODS, INC.
(formerly KRAFT, INC.),

Petitioner,

v.

IOWA DEPARTMENT OF REVENUE
AND FINANCE,

Respondent.

ON WRIT OF CERTIORARI TO
THE SUPREME COURT OF IOWA

BRIEF OF *AMICUS CURIAE* THE WASHINGTON LEGAL FOUNDATION IN SUPPORT OF PETITIONER

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INTERESTS OF THE *AMICUS CURIAE*

The Washington Legal Foundation (WLF) is a non-profit public interest law and policy center based in Washington, D.C. with over 100,000 members and supporters nationwide.[1] WLF regularly appears before federal and state courts promoting economic liberty, free enter-

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[1] By letters filed with the Clerk of the Court, the parties have consented to the filing of this brief.

prise principles, and a limited and accountable government. WLF has devoted substantial resources to litigating cases before this Court that involve impermissible attempts to usurp the unique role of the federal government and the Executive Branch in the conduct of foreign affairs or where foreign affairs considerations were involved in the resolution of the case. *See, e.g., Perpich v. U.S. Dep't of Defense*, 110 S.Ct. 2418 (1990); *Equal Employment Opportunity Comm'n v. Arabian American Oil Co.*, 111 S.Ct. 1227 (1991).

Amicus will present a broader perspective of the issues presented in this case which will assist this Court in deciding them and will focus on the Foreign Commerce Clause question before the Court.

STATEMENT OF THE CASE

In the interests of brevity, WLF is omitting any detailed statement of the facts of this case. WLF adopts by reference the statement of facts contained in the Petitioner's brief.

The essential characteristic of the Iowa tax statute which is in issue here, Iowa Code Ann. §§ 422.33, 422.35, is the adoption of the federal definition of taxable corporate income, which includes dividends received from subsidiaries incorporated abroad, and excludes dividends received from domestically incorporated subsidiaries. This facial discrimination is compounded by Iowa's refusal, in contrast to the federal tax statutes, to provide a tax credit for foreign taxes paid on account of the same foreign dividends included within the definition of corporate income.

The tax scheme in issue is essentially identical to that upheld by the Court in *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980) ("*Mobil*"). However, in *Mobil*, the Court was not presented with, and did not consider, the discriminatory effects of the distinction in the tax treatment of dividends depending on

whether they originate domestically or abroad.[1] In this case, in contrast, Iowa's disparate treatment of dividends, depending solely on the domicile of the corporation paying those dividends, is squarely at issue.

SUMMARY OF ARGUMENT

The Iowa income tax provisions in issue here are discriminatory on their face. They provide that dividends received from foreign subsidiaries are subject to Iowa income tax, while dividends from domestic subsidiaries are exempt from that tax. The direct effect of those provisions is that they constitute a duty imposed on the import of dividends, and the indirect effect is to discourage investment in foreign corporations. That discrimination is contrary to the limitations placed on state tax powers by both the Foreign Commerce Clause and the Import-Export Clause of the Constitution, and constitutes an impermissible intrusion into the exclusive foreign affairs jurisdiction of the federal government.

ARGUMENT

I. INTRODUCTION

There is no question that the investment activities of a company which invests in the stock of subsidiary corporations and receives dividends from those corporations constitutes commerce within the purview of the Commerce Clause of the Constitution of the United States.[2] *North American Co. v. Securities and Exchange Comm'n*, 327 U.S. 686, 693-96 (1946). As this Court long has recog-

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[1] Indeed, in *Mobil*, the Court appears to have assumed, for purposes of the decision, that Vermont's tax scheme treated all dividends as income. Mobil apparently sought to justify exclusion from income of any dividends arising from foreign operations, regardless of whether the dividends were received from a foreign or a domestic corporation. 445 U.S. at 435-36.

[2] U.S. Const., Art. I, § 8, cl. 3.

nized, the purchase and sale of securities and the transmission of dividends constitute interstate commerce when conducted across state lines. *Id.*[3]

As interstate commerce, the transmission of investment capital and the receipt of dividend income are as much the subject of regulation and protection by the federal government, and as entitled to freedom from discriminatory intrusions by state regulation, as the shipment of freight containers,[4] or the sale of cement.[5] Indeed, to the extent that constitutional analysis may require application of stricter standards when reviewing regulation of the instrumentalities of commerce,[6] as opposed to mere commodities, this Court should recognize that the transmission of capital, and the flow of dividends constituting a return on that capital, are among the central instrumentalities of the modern conduct of commerce.

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[3] "[T]he flow, through underwriting channels, of millions of dollars of securities has been of great value and benefit to North American, in addition to being of aid to the subsidiaries." 327 U.S. at 694. "The mails and the instrumentalities of interstate commerce are vital to the functioning of this system. . . . Without them, North American would be unable to exercise and maintain the influence arising from its large stock holdings, receiving notice and reports, sending proxies to stockholders' meetings, collecting dividends and interest. . . ." *Id.* (citations omitted).

[4] *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979) ("*Japan Line*").

[5] *Hale v. Bimco Trading, Inc.*, 306 U.S. 375 (1939) ("*Hale v. Bimco*").

[6] *See Mobil*, 445 U.S. at 448; *Japan Line*, 441 U.S. at 445-46. "Instrumentalities of commerce" traditionally have been defined as "tangible property used as an instrument of interstate commerce." "Indirect Encroachment on Federal Authority by the Taxing Powers of the States," 32 Harv. L. Rev. 234, 236 (1919). However, a tax on the contents of all dividends from foreign corporations is effectively a tax on commercial use of the "instrument" of dividends, when used to transmit earnings from abroad.

Such truisms bear repeating here, because the issue presented is the constitutionality of a statutory scheme which, on its face, imposes a tax burden on the receipt of dividends from foreign subsidiaries which is not imposed on the receipt of dividends from domestic subsidiaries. The net effect[7] of the Iowa tax statute in issue is to impose a special tax on the importation of dividends from abroad, and thereby discourage investment in foreign subsidiaries.

The rationale offered by the State of Iowa for adoption of this tax scheme is simplicity of operation. The State contends that adoption of the federal definition of "income" simplifies corporate paperwork while giving Iowa the advantage of federal audits and enforcement of income reporting requirements. *Kraft, Inc. v. Iowa Dep't of Revenue and Finance*, 465 N.W.2d 664, 669 (1991). That rationale, however sincere, suffers from two fatal flaws.

First, the federal taxation scheme provides a credit to the corporate parent for foreign taxes paid on the foreign subsidiary's income stream which gave rise to the dividends declared as income to the corporate parent. As a result, foreign dividends are not taxed in excess of the burden imposed by federal income taxes on the domestic subsidiary corporations, whose dividends are excluded from the definition of income to the parent corporation. Thus, even though the federal tax scheme treats domestic dividends differently from foreign dividends, it arguably does not favor one class of dividends over the other.

When Iowa failed to adopt the credit for foreign taxes, while including the dividends from foreign subsidiaries within the definition of income to the parent, Iowa imposed a discrimination against foreign investment never intended by the federal tax code or regulations. Had Iowa

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[7] This Court long has held that it will examine the effect of a tax as well as the face of the statute. *Nippert v. Richmond*, 327 U.S. 416, 431 (1946).

adopted the federal foreign tax credit in conjunction with the federal definition of income, it could argue now that it did not discriminate against investment in foreign corporate subsidiaries. However, under the facts presented in this case, Iowa cannot deny that it imposes additional taxes on corporations, on the basis of their foreign investments, not levied on the return from identical domestic investments.

The second, and more fundamental, problem with Iowa's corporate income tax, however, is Iowa's failure to recognize that it may not borrow federal tax provisions without regard to their effect on foreign commerce. The Constitution places limits upon the states which are not placed upon the federal government. The United States is permitted to discriminate against foreign commerce by the imposition of taxes applicable solely to that commerce. The states, in contrast, are forbidden from taking such measures. Thus, Iowa's tax on foreign dividends must be struck down once it is shown to discriminate against commerce with foreign corporations.

II. THE IOWA TAXING SCHEME IMPERMISSIBLY DISCRIMINATES AGAINST COMMERCE WITH FOREIGN CORPORATIONS

"[A] tax must have 'what might be called internal consistency -- that is the [tax] must be such that, if applied by every jurisdiction,' there would be no unpermissible interference with free trade." *Armco Inc. v. Hardesty*, 467 U.S. 638, 644 (1984), quoting from *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 169 (1983) ("*Container Corp.*").

The Iowa tax in issue cannot pass that test. If the same tax were imposed by all of the states,[8] it would

[8] "[The] conclusion that a tax facially discriminates against interstate commerce need not be confirmed by an examination of the tax burdens imposed by other States . . . ." *Tyler Pipe Indus., Inc. v. Washington State Dep't of Revenue*, 483 U.S. 232, 247 (1987) ("*Tyler Pipe*").

create an obvious, and impermissible, interference with the right to invest in foreign subsidiaries, and to receive a return on that investment subject to the same state taxes imposed on investments in domestic corporations. *See Ashland Oil, Inc. v. Caryl*, ____ U.S. ____, 110 S. Ct. 3202, 3205 (1990).

The answer to one simple question demonstrates the fundamental failure of the Iowa tax scheme. If Iowa simply imposed an income tax on income received from investment in foreign companies, and did not impose a tax on income received from domestic investments, would that tax be constitutionally permissible? Surely, it would not, or isolationism could be imposed state by state. This Court long has held to the contrary.

The import and export of funds across national lines is a subject of regulation solely for the federal government. The question now presented is whether the State of Iowa, simply by adopting a federal statutory scheme which exercises the federal power to tax income differently depending on whether it originates domestically or abroad, can accomplish that which it may not do directly. Surely, the answer must be "no".

A. Iowa's Tax Scheme Discriminates Against Dividend Imports and Capital Exports

The importation of dividends from foreign corporations, whether in cash or in kind, cannot be placed at a substantial commercial disadvantage through discriminatory state tax treatment. *See New Energy Co. of Indiana v. Limbach*, 486 U.S. 269, 273 (1988). "[W]here simple economic protectionism is effected by state legislation, a virtually *per se* rule of invalidity has been erected." *Philadelphia v. New Jersey*, 437 U.S. 617, 624 (1978).

On its face, the Iowa income tax scheme imposes a type of duty or excise on the importation of dividends from abroad. The fact that the tax in question is essentially a duty is immediately apparent when one recalls that

a dividend can as easily be made by a distribution in kind, as by a payment in cash. *General Utils. & Operating Co. v. Helvering*, 296 U.S. 200, 202 (1935). Thus, under Iowa's tax provisions, if Petitioner, Kraft General Foods, Inc. ("Kraft"), were to receive identical dividends from a Danish subsidiary and a Wisconsin subsidiary, both in the form of a quantity of butter, one would be taxed and the other would not.[9] The imposition by the State of Iowa of a tax on the receipt of Danish butter, from which Wisconsin butter was exempt, clearly would be an improper tax on foreign trade by the state. The substitution of cash for butter does not make that same discrimination permissible.

In summary, the Iowa tax code provisions at issue here deprive investors of the right to establish or acquire foreign subsidiaries subject to the same beneficial state tax treatment afforded to investments in subsidiaries incorporated in the United States. The fundamental effect of those provisions is to discourage corporations that wish to do business in Iowa from exporting capital for investment abroad.[10]

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[9] Under Iowa's tax provisions, if Kraft either sold any butter, or used it as an ingredient in products which it sold, the receipt of a butter dividend would constitute income received in the course of the unitary business which Iowa is taxing. Kraft's sales in Iowa will be taken into account as Iowa income, however, regardless of whether or not the receipt of the dividend is added as an additional item of income. *See Moorman Mfg. Co. v. G. D. Bair*, 437 U.S. 267, 269-71, 283-85 (1978), where the Court previously discussed the operation of Iowa's provisions for allocation of a corporation's income from operation of a unitary business among the jurisdictions where that business operates.

[10] That such measures constitute export restrictions is apparent given that investment capital, as well as dividends, may be transferred in kind as an alternative to cash. *Wilgard Realty Co. v. Commissioner of Internal Revenue*, 127 F.2d 514, 515 (2d Cir.), *cert. denied*, 317 U.S. 655 (1942).

In these times of economic turmoil, such measures have a dangerous appeal. It is not hard to imagine Michigan seeking to discourage automobile manufacturers from exporting capital to acquire foreign subsidiaries for parts manufacture and assembly, or California taking similar measures with respect to the electronics industry.

B. Discrimination Against Foreign Commerce Violates the Commerce Clause

As this Court said in *New Energy Co. of Indiana v. Limbach*, 486 U.S. 269, 273 (1988), "the Commerce Clause prohibits economic protectionism -- that is, regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors."

In *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980) ("*Mobil*"), this Court held that a state may tax a proportionate share of a corporation's dividend income received in the form of dividends from foreign subsidiaries and affiliates doing business abroad. However, in that case, it appears that the sole basis of the challenge was that the foreign income was not capable of "fair and equitable" apportionment between business done within and outside Vermont. 445 U.S. at 432.

Mobil's central contention was that Vermont's tax formula raised the potential for multiple taxation, because of the possibility that Mobil's domiciliary state, New York, could tax the entirety of Mobil's dividend income. 445 U.S. at 433. Mobil apparently did not raise any issue as to discrimination between the tax treatment of dividends from domestic subsidiaries and those from foreign corporations. Indeed, the Court recognized that the dividends at issue in *Mobil* came from both sources, 445 U.S. at 435, although the Court noted in passing, without comment, that the dividends from domestic subsidiaries were "subject to apportionment only in part." *Id.* at n.12. The Court, however, did not consider the constitutional implications of

state discrimination between dividends from domestic and foreign corporations.

Mobil took the position that dividends remitted as a result of foreign operations never can be subjected to state taxation. That is not the position now advanced by *amicus* WLF. Instead, the WLF asserts only that the states may not discriminate against investment in foreign companies by imposing a greater tax burden on dividends from such companies than the tax imposed on the returns from domestic investments. That issue was not addressed in *Mobil*. Therefore, *Mobil* is not controlling here.

"Foreign commerce is pre-eminently a matter of national concern. 'In international relations and with respect to foreign intercourse and trade the people of the United States act through a single government with unified and adequate national power.' *Board of Trustees v. United States*, 289 U.S. 48, 59 (1933). Although the Constitution, Art. I, §8, cl. 3, grants Congress power to regulate commerce 'with foreign Nations' and 'among the several States' in parallel phrases, there is evidence that the Founders intended the scope of the foreign commerce power to be greater." *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 448 (1979) (footnote omitted) ("*Japan Line*").

"It is a well-accepted rule that state restrictions burdening foreign commerce are subjected to a more rigorous and searching scrutiny." *South-Central Timber Dev., Inc. v. Wunnicke*, 467 U.S. 82, 100 (1984). *See Japan Line*, 441 U.S. at 446, where the Court stated that: "[t]he premise of appellees' argument is that the Commerce Clause analysis is identical, regardless of whether interstate or foreign commerce is involved. This premise, we have concluded, must be rejected. When construing Congress' power to 'regulate Commerce with foreign Nations,' a more extensive constitutional inquiry is required."

"Besides being fair, an apportionment formula must, under the Commerce Clause, also not result in discrimination against interstate or foreign commerce." *Container Corp.*, 463 U.S. at 170. In *Container Corp.*, the Court found that the tax in issue did not create an "*automatic* 'asymmetry' in international taxation." 463 U.S. at 195 (emphasis in original). In the present case, however, the imposition of a tax on remittances from foreign corporations, from which domestic corporations are exempt, automatically does treat foreign corporations "asymmetrically." If such an imposition is allowed to stand, the federal government is not capable of speaking with one voice on the subject of how foreign corporations will be treated in international commerce with this country.[11]

Because the tax in question is imposed solely on the import of dividends from foreign corporations, this case is fundamentally different from *Wardair Canada, Inc. v. Florida Department of Revenue*, 477 U.S. 1, 4, 9 (1986) ("*Wardair*"), where this Court upheld a Florida tax on aviation fuel sales, which applied equally to all purchasers, regardless of their destination upon flight. In the present case, the Iowa tax on the receipt of dividends applies only to those sent from abroad. Such a facial discrimination against the import of dividends is a direct violation of the limitations on state taxation imposed by the Foreign Commerce Clause.

III. THE RIGHT TO REGULATE FOREIGN COMMERCE IS RESERVED TO THE FEDERAL GOVERNMENT

"That the supremacy of the national power in the general field of foreign affairs, . . . is made clear by the Constitution was pointed out by the authors of the

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[11] *See* the dissent of Justice Powell in *Container Corp.*, 463 U.S. at 204, citing the Memorandum for the United States as *Amicus Curiae* in *Chicago Bridge & Iron Co. v. Caterpillar Tractor Co.*, O.T. 1982, No. 81-349.

Federalist in 1787, and has since been given continuous recognition by this Court." *Hines v. Davidowitz*, 312 U.S. 52, 62 (1941) (footnote omitted).

The Framers of the Constitution committed "sole power to lay imposts and duties on imports in the Federal Government, with no concurrent state power: the Federal Government must speak with one voice when regulating commercial relations with foreign governments, and tariffs, which might affect foreign relations, could not be implemented by the States consistently with that exclusive power . . . ." *Michelin Tire Corp. v. Wages*, 423 U.S. 276, 285 (1976) ("*Michelin Tire*").

The Import-Export Clause of the Constitution[12] prohibits the imposition of taxes by a state which are addressed to a particular category of foreign commerce. If a state decides to impose a tax on some form of commercial transaction, it must be a nondiscriminatory tax, falling equally on domestic and foreign transactions. "By definition, such a tax does not fall on imports as such because of place of origin. It cannot be used to create special protective tariffs or particular preferences for certain domestic goods, and it cannot by applied selectively to encourage or discourage any importation in a manner inconsistent with federal regulation." *Michelin Tire*, 423 U.S. at 286.

IV. WHERE CONGRESS HAS CHOSEN TO ALLOW FREE IMPORT AND EXPORT OF CAPITAL AND DIVIDENDS, THE STATES MAY NOT INTERFERE BY DISCRIMINATORY TAXATION

[12] U.S. Const., Art. I., § 10, cl. 2, which provides in pertinent part that: "No State shall, without the consent of the Congress, lay any Imposts or Duties on Imports or Exports, except what may be absolutely necessary for executing its inspection Laws . . . ."

The WLF does not contend that the states must treat dividends received from abroad in a manner identical to their treatment at the federal level.[13] To the contrary, even where the federal government seeks to restrain foreign commerce by the imposition of duties or levies, the states may not enhance that restraint by imposing their own additional burden. *See South-Central Timber Development, Inc. v. Wunnicke*, 467 U.S. 82, 92-93 (1984), which held that a federal statute, requiring that timber cut from federal lands in Alaska be processed in Alaska before shipment out of the state, did not implicitly permit the State of Alaska to impose the same requirement with respect to timber cut from state lands.

All that is required of the states is that they treat the import of income, and the export of capital, even-handedly, imposing no greater burden based on the foreign source or destination of the funds. The State of Iowa, however, has failed to meet that requirement.

In the opinion below, the Supreme Court of Iowa rejected Kraft's challenge to the discriminatory taxation of dividends from foreign subsidiaries on the basis that discrimination is unconstitutional only if there is a showing of a particular advantage to local businesses within the taxing state. *Kraft, Inc. v. Iowa Dep't of Revenue and Finance*, 465 N.W.2d 664, 668 (Ia. 1991) ("we hold that Kraft must show, as in the case of alleged interstate discrimination, that Iowa businesses receive a commercial advantage over foreign commerce due to Iowa's taxing scheme"). That, however, has never been the law in this Court. As early as 1878, this Court held that a Pennsylvania tax on goods sold at auction, which exempted goods made in America, was unconstitutional, without requiring any showing that Pennsylvania merchants thereby derived

[13] *See Mobil*, 445 U.S. at 448, apparently holding that the states need not be concerned with multiple taxation when taxing income from abroad. *See id.*, 445 U.S. at 445-46, noting that no constitutional infirmity is presented by the possibility that the same income may be taxed by more than one state.

a commercial advantage over other domestic producers. *Cook v. Pennsylvania*, 97 U.S. 566, 573 (1878). The Iowa Supreme Court erred by ignoring Kraft's discussion of the *Cook* decision in its briefs to that court.[14]

The essential error in the Iowa Supreme Court's analysis is that it assumes that a factual showing of competitive disadvantage is required, even where discrimination is apparent on the face of the statute. This Court held to the contrary in *Tyler Pipe*. As shown by that case, a simple examination of the effect of a tax, if uniformly applied by all states, can demonstrate an impermissible discrimination. 483 U.S. at 247.

In its opposition to the Petition for Certiorari, the Iowa Department of Revenue and Finance argued that the state tax on foreign dividends does not burden unitary businesses unfairly because the parent's income taxes are apportioned to tax only the portion of business done in Iowa. (Br. Opp. at 8-10). That argument, however, ignores the fact that a subsidiary's business activities in Iowa are the subject of separate Iowa income taxes paid by that subsidiary.

The weakness of the hypothetical business arrangements posited by Iowa is demonstrated by Iowa's failure to discuss the tax implications of identical scenarios, where only the state of the subsidiary's incorporation is changed. For example, consider a corporation that has two subsidiaries. Subsidiary A is a domestic corporation that does 50 percent of its business in Iowa. Subsidiary B is a foreign corporation, which does half of its business in a foreign country and does the remaining 50 percent of its business in Iowa. Both of the subsidiaries will pay Iowa income tax to the extent that they do business in Iowa.

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[14] *See also Hale v. Bimco Trading, Inc.*, 306 U.S. 375 (1939), which overturned a tax on foreign cement as discriminatory without any showing that Florida cement manufacturers thereby gained a peculiar advantage vis-a-vis other American cement manufacturers.

The parent corporation, however, will pay additional income tax on dividends received from the foreign subsidiary on account of foreign operations, in excess of whatever Iowa taxes are paid by both the foreign and the domestic subsidiaries. That additional tax, which will be imposed in proportion to the parent's Iowa business, arises solely because of the corporation's investment in a foreign corporation. The Iowa Department of Revenue has not shown, and cannot show, that the additional tax is anything other than an imposition on foreign commerce.

In the present case, if all states adopted Iowa's tax scheme, foreign investment clearly would be discouraged, and a preference shown for domestic investment. That fact compels the conclusion that Iowa's tax scheme is an impermissible intrusion into the regulation of foreign commerce, a matter reserved to the federal government.

CONCLUSION

For the foregoing reasons, the decision of the Supreme Court of Iowa should be reversed.

Respectfully submitted,

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